

September 29, 2008

The Evolving “Bailout” Proposal – Emergency Economic Stabilization Act of 2008

The Administration, working with U.S. Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke, proposed legislation¹ last week that would provide for the U.S. government’s purchase of \$700 billion of illiquid mortgage and other assets currently held on the books of U.S. financial institutions. Following a week of intense negotiations among key Democrats and Republicans on Capitol Hill, negotiators announced this weekend that an agreement had been reached on key provisions of the “Emergency Economic Stabilization Act of 2008.” On Sunday, the Senate Banking, Housing, and Urban Affairs Committee released the full text of the proposed bill,² together with an executive summary³ and section-by-section summary⁴. This afternoon, the House has voted down the current proposal by a vote of 228-205. However, given the dramatic adverse effect the negative vote has had on the markets, it can be anticipated that further changes to the bill may be made and that legislation in some form will be passed. Senate consideration of the bill will not occur until House approval, but the Senate, along with the Administration, will be involved in any renegotiation of the present proposal.

Troubled Asset Relief Program. The proposed bill would authorize \$700 billion⁵ to establish the Troubled Asset Relief Program (“TARP”), which provides powers to purchase, manage, and sell “troubled assets” (which include residential and commercial mortgages, and securities, obligations, and other instruments based on or related to such mortgages, in each case originated or issued on or prior to March 14, 2008) held by “financial institutions” (which include banks, thrifts, credit unions, broker dealers, and insurance companies). Key provisions of TARP include the following:

- (1) Establishment of the Troubled Assets Insurance Financing Fund (“TAIFF”), which would provide financial institutions with the ability to purchase insurance from the government to guarantee their troubled assets.
- (2) In exchange for the government’s purchase of troubled assets, participating financial institutions must issue a warrant that is convertible into non-voting common or preferred equity, or senior debt securities.
- (3) The Treasury Secretary may, upon a determination of urgent and compelling circumstances, streamline the contracting process by waiving specific provisions of the Federal Acquisition Regulation. The Federal Deposit Insurance Corporation (“FDIC”) may be selected as asset manager for residential mortgage loans and related securities.
- (4) TARP and TIAFF will sunset December 31, 2009, but the Treasury Secretary may authorize an extension through the 2-year anniversary of the bill’s enactment by certifying to Congress that such an extension is necessary.

¹ Available at <http://www.nytimes.com/2008/09/21/business/21draftcnd.html>.

² Available at <http://www.sutherland.com/files/upload/September29BailOutBill.pdf>.

³ Available at <http://www.sutherland.com/files/upload/summaryoftheeesa.pdf>.

⁴ Available at <http://www.sutherland.com/files/upload/finalbillsectionbysection.pdf>.

⁵ \$250 billion authorized immediately, \$100 billion authorized upon a Presidential certification of need, and the remaining \$350 billion contingent upon a Presidential report to Congress requesting such authority (and subject to disapproval by joint resolution of Congress).

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Oversight. The proposed bill includes the following external oversight mechanisms:

- (1) A Financial Stability Oversight Board, comprised of the Federal Reserve Chairman, Treasury Secretary, Federal Home Finance Agency Director, Chairman of the Securities and Exchange Commission (“SEC”), and Housing and Urban Development Secretary.
- (2) The Governmental Accountability Office (“GAO”) will oversee the operations of TARP, conduct annual audits, and make reports to relevant Congressional committees every 60 days. The GAO must also submit a report to Congress no later than June 1, 2009, that addresses the extent to which leverage was a factor in the current financial crisis.
- (3) A Special Inspector General, appointed by the President with the advice and consent of the Senate, will have investigatory authority over TARP and be responsible for making quarterly reports to Congress.
- (4) A Congressional Oversight Panel, comprised of 5 members of Congress (2 each from the majority and minority parties, and 1 selected by the majority leaders of the House and Senate in consultation with the minority leaders), shall review the financial markets and regulatory system and make reports to the Treasury Secretary every 30 days, as well as issue a special report on regulatory reform no later than January 20, 2009.

Reports & Studies. The proposed bill requires that the following reports be made to Congress:

- (1) Within 60 days following the first exercise of authority by the Treasury Secretary under the law, and every 30 days thereafter, the Secretary must provide a report on its activities to Congress that includes detailed financial statements.
- (2) Within 7 days after each aggregate purchase of \$50 billion of troubled assets, the Treasury Secretary must provide a written tranche report to Congress showing all transactions made during such period and justifying the prices paid for such transactions.
- (3) Prior to April 30, 2009, the Treasury Secretary must submit a written report to Congress analyzing the effectiveness of the regulatory system, including an assessment of whether certain participants in the financial markets should be regulated, and the enhancement of settlement and clearance of over-the-counter swaps.
- (4) Within 2 business days of any purchase, trade, or other disposition of troubled assets, the Treasury Secretary must make description, amount, and pricing information of such transaction available to the public in electronic form.
- (5) Within 90 days of enactment, the SEC, in consultation with the Federal Reserve Board of Governors and the Treasury Secretary, must submit a report to Congress outlining the impact of Statement No. 157 of the Financial Accounting Standards Board (“FAS 157”) relating to mark-to-market accounting and the advisability of alternative standards. In addition, the proposed bill provides the SEC with the authority to suspend application of FAS 157.

Protection. Congress has included the following provisions to protect certain parties from losses relating to mortgages and mortgage-backed securities:

- (1) With regard to troubled assets acquired by the Treasury Secretary under TARP, or mortgages or related securities held by other federal agencies (such as the Federal Housing Finance Agency, the FDIC, and the Federal Reserve), the applicable agencies

are required to work to minimize foreclosures by encouraging servicers of the mortgages underlying such assets to utilize federal programs (including the HOPE for Homeowners Program). The applicable agency may, where appropriate, modify existing mortgages to provide for loss mitigation measures. Such actions must also be taken with regard to mortgages on residential rental property in order to protect bona fide renters from rent increases or the loss of their residence. The bill also extends to January 1, 2013 the exclusion from income due to the forgiveness of debt on qualifying principal residences.

- (2) Changes regarding the tax treatment of losses on preferred stock of government sponsored enterprises, such as Fannie Mae and Freddie Mac, in order to protect community banks with assets less than \$1 billion who have been significantly impacted by the dramatic devaluation of such stock.

Executive Compensation Limits. Financial institutions participating in TARP at a substantial level will be subject to a variety of executive compensation limitations:

- (1) In general, the tax deduction for compensation paid to top officers (usually, the Chief Executive Officer, Chief Financial Officer, and the other three highest-paid) will be limited to \$500,000 per officer, and per-officer deductions for deferred compensation will be limited to \$500,000. A 20% excise tax and a loss of the tax deduction will apply to certain "golden parachute" severance and similar payments to executives.
- (2) Additional restrictions apply to institutions in which the Treasury holds a significant equity or debt position, including limits on the types of incentive compensation permitted, required "clawback" of compensation following a restatement or similar event, and a prohibition on golden parachute payments.
- (3) For institutions participating in a Treasury auction process for troubled assets, there is also a prohibition on new golden parachute arrangements.

Sutherland Regulatory Reform Task Force

In the wake of the recent credit crisis, regulators and Congress are accelerating their efforts to address the governmental oversight of U.S. financial markets. The current bail out and adverse economic conditions have assured action by Congress as it questions whether our existing regulatory regime can adequately maintain the competitiveness and integrity of our financial system and provide appropriate protection to investors and consumers. To help our clients respond to this ever-changing market place and evolving regulatory landscape, we formed a Regulatory Reform Task Force in June of this year that is made up of a diverse group of lawyers with experience in banking, securities, insurance, energy regulation and enforcement. Please click [here](#) for more information on Sutherland's Regulatory Reform Task Force.



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